

Mercia Asset Management

FY19 results

Scaling regional powerhouse

Mercia's FY19 results reflect continued progress across the portfolio, with the company in good shape for further growth. Net assets rose 2% to £126.1m, but FUM fell 5% to £381m due to the winding up of the successful RisingStars Growth Fund (15% IRR, TVPI of 528%). The direct investment portfolio increased to £87.7m, with £19.4m of cash invested in 17 companies, as well as £3.9m of fair value uplift. Mercia remains well positioned for further progress in FY20 with key portfolio companies strategically well placed, together with firepower from the group's £168m of free cash and £30m of unrestricted balance sheet cash. The shares continue to trade at a significant discount to NAV (0.77x), even before considering the embedded value of Mercia Fund Managers (10p+).

Period end	Net cash* (£m)	Direct investments (£m)	FUM (£m)	NAV (£m)	NAV per share (p)	P/NAV (x)
03/16	30.9	38.1	220.0	80.0	26.4	1.20
03/17	59.6	52.0	336.5	121.4	40.0	0.79
03/18	49.4	66.1	400.0	123.5	40.7	0.78
H119	38.3	77.8	394.9	125.2	41.3	0.77
03/19	29.8	87.7	381.0	126.1	41.6	0.77

Note: *Includes liquid securities but not funds held on behalf of EIS investors.

32.7% growth in direct investment portfolio

Mercia reported FY19 net assets of £126.1m (FY18: £123.5m). The direct investment portfolio grew by 32.7% to £87.7m. In Mercia Fund Managers, FUM fell 5% to £381m with the winding up of the successful RisingStars Growth Fund (15% IRR, TVPI of 528%). Net expenses rose to £1.4m (FY18: £0.4m), largely due to a one-off performance-related fee received in FY18, and staff and administrative expenses rose 13.9% as headcount was expanded to manage mandates won in FY18. Management reiterated its intention to achieve a sustainable position in the medium term, where revenue covers expenses before realised gains and fair value movements.

Brand repositioning: Mercia Asset Management

Mercia has changed its name to Mercia Asset Management to better reflect the balance of the business. Its stated intent remains to become the leading regional provider of supportive balance sheet, venture, private equity and debt capital in transaction sizes typically below £10m. Historically, Mercia has been closely associated with IP commercialisation. However, this categorisation no longer reflects the growth of the business, the diversity of its deal sourcing or the breadth of its investment portfolio, both debt and equity. IP commercialisation remains an important element of Mercia's investment proposition, but today represents one of five principal sources of deal flow.

Valuation: 0.77x NAV, does not include MFM

Mercia's shares continue to trade at a discount to NAV (0.77x), even before considering the embedded value of Mercia Fund Managers, which we believe should add 10p+ to NAV. Catalysts for a re-rating include meaningful commercialisation of the direct investment portfolio and/or further successful exits.

Investment companies

8 July 2019

Price 31.8p
Market cap £96m

Net cash (£m) at 31 March 2019	29.8
Shares in issue	303.3m
Free float	47.3%
Code	MERC
Primary exchange	AIM
Secondary exchange	N/A

Share price performance



%	1m	3m	12m
Abs	1.6	(5.6)	(4.5)
Rel (local)	(3.3)	(7.9)	(4.0)
52-week high/low		38.7p	27.5p

Business description

Mercia Asset Management is a regionally focused specialist asset manager. Its stated intent is to become the leading regional provider of supportive balance sheet, venture, private equity and debt capital in transaction sizes typically below £10m.

Next event

AGM	September 2019
Half year results	December 2019

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FY19 results review

Small rise in net assets

Mercia reported a net asset value of £126.1m at end FY19 (vs £123.5m at end FY18) or 41.6p per share (FY18: 40.7p), representing a small rise of 2% over the year. Direct investment of £19.4m was made into 17 portfolio companies (FY18: £21.1m, 17 companies) during the year, including two new direct investments, W2 Global Data Solutions and Locate Bio. Largely as a result of the £19.4m of direct investment, unrestricted cash and short-term liquidity investments fell from £49.4m at end FY18 to £29.8m at end FY19, in line with management guidance.

Funds under management (FUM) fell by 4.8% to £381.3m, from £400m at FY18. This fall in FUM was largely attributable to the winding up of the successful RisingStars Growth Fund, an early-stage fund that generated an investor IRR of 15% over its lifetime, total value to paid-in capital (TVPI) of 528% and distributions as a proportion of paid in capital (DPI) of 468%. The demonstrable success of this fund and the returns delivered to investors positions the group well to raise further funds in the future.

Group revenues increased by 4.7% to £10.7m (FY18: £10.2m), largely due to the full year contribution from fund management contracts won during FY18, split £7.3m from fund management fees, £1.1m from initial management fees and £2.1m from portfolio director fees. The prior year comparison was also flattered by a one-off £1.2m performance-related fund management fee.

Net expenses rose to £1.4m (FY18: £0.4m) due to the one-off performance-related fee, and staff and admin expenses of 13.9% to £12.1m (FY18: £10.6m), reflecting an increase in headcount (from 65 to 85 over the course of the year) required to manage the FY18 fund mandate wins.

Management expects net expenses to level off for FY20. Management also reiterated its intention to achieve a sustainable zero net expenses position in the medium term, where revenues cover expenses before realised gains and fair value movements, to minimise NAV erosion.

Portfolio review: Direct investment up 32.7% vs prior year

Mercia's direct investment portfolio grew from £66.1m in FY18 to £87.7m in FY19, with net portfolio investment of £17.7m (£19.4m less a £1.7m loan repayment), together with a fair value increase of £3.9m (FY18: £2.8m). Like previous reporting periods, Mercia's top 20 direct investments represented 98.4% of total portfolio value.

Notable fair value uplifts included: nDreams (£1.1m); Intelligent Positioning (£1.3m); Faradion (£1.6m); Oxford Genetics (£0.6m); Medherant (£1.2m); The Native Antigen Company (£0.9m); and Voxpopme (£0.5m). On the downside, as well as the fair value write-off of Smart Antenna Technologies, Mercia also reflected a negative fair value movement of £0.5m on Concepta, recognising market movements on the AIM listed investment. A previous fair value provision for Soccer Manager was released as the company's prospects were deemed to have materially improved with an acceleration in revenues, following Mercia's proactive intervention.

Post year-end developments are as follows:

- Further funding rounds for Voxpopme (£1.3m), Medherant (£1.5m) and Locate Bio (£1.8m).
- £0.8m investment into MyLotus developer, Concepta, as part of a £2.3m placing in April 2019.
- £0.5m invested into a new direct investment, Clear Review, a fast-growing SaaS business providing HR management tools.
- nDreams announced a partnership with global technology company Oculus (Facebook), developing its first title – Phantom: Covert Ops. This received significant industry recognition including the Game Critics Award for the best VR/AR game at the E3 Expo in June 2019.

Exhibit 1: nDreams – Oculus partnership for Phantom: Covert Ops


Source: nDreams, YouTube

Exhibit 2: Direct investment portfolio

£000s	Sector	Net value 1/4/18	Net value 30/9/18	Net cash invested FY19	Fair value change FY19	Net value 31/3/19	% held at 31/3/19
nDreams	Digital/digital entertainment	12,979	12,979	1,029	1,112	15,120	45.5
Oxford Genetics	Life sciences/biosciences	9,090	9,090	433	638	10,161	33.3
Warwick Acoustics	EMME	6,152	7,152	1,500	252	7,904	62.5
Intechnica	Software and the internet	4,021	4,677	2,000	656	6,677	32.0
Ton UK t/a Intelligent Positioning	Software and the internet	4,216	4,216	-	1,257	5,473	28.8
Impression Technologies	EMME	3,107	4,607	2,268	6	5,381	31.4
Medherant	Life sciences/biosciences	3,453	3,453	524	1,228	5,205	31.9
VirtTrade t/a Avid Games	Digital/digital entertainment	2,538	3,088	1,400	-	3,938	28.4
Faradion	EMME	1,299	3,524	601	1,625	3,525	18.1
Voxpopme	Software and the internet	1,000	3,026	1,500	526	3,026	21.8
The Native Antigen Company	Life sciences/biosciences	1,942	2,324	-	921	2,863	32.7
PsiOxus Therapeutics	Life Sciences/biosciences	2,377	2,377	-	-	2,377	1.5
Edge Case Games	Digital/digital entertainment	2,000	3,150	300	-	2,300	21.2
Soccer Manager	Digital/digital entertainment	1,199	1,499	500	400	2,099	31.6
W2 Global Data Solutions	Software and the internet	-	-	2,000	-	2,000	17.4
LM Technologies	EMME	1,913	1,913	-	-	1,913	41.4
sureCore	EMME	1,500	1,834	334	-	1,834	24.4
Aston EyeTech t/a Eyoto	Life sciences/biosciences	1,750	1,750	4	1	1,755	18.7
Crowd Reactive	Software and the internet	1,650	1,637	(61)	-	1,589	26.2
Concepta	Life sciences/biosciences	1,306	1,203	365	(538)	1,133	18.2
Locate Bio	Life sciences/biosciences	-	-	500	-	500	6.0
Smart Antenna Technologies	EMME	2,148	3,348	1,900	(4,048)	-	32.2
Other direct investments		430	980	576	(120)	886	n/a
Total		66,070	77,827	17,673	3,916	87,659	n/a

Source: Mercia. Note: EMME is Electronics, Materials, Manufacturing and Engineering. Excludes post year-end investments.

Valuation: Mercia looks undervalued at 0.77x NAV

In line with Mercia's intent to become the leading regional provider of supportive balance sheet, venture, private equity and debt capital in transaction sizes typically below £10m, we have broadened Mercia's valuation peer group to include a broader range of direct private equity and venture capital investors, as well as IP commercialisation companies.

Mercia trades at a 23% discount to FY19 NAV, below the mean and median of the peer group and, in our view, unwarranted given the strength of the business and its underlying operating model.

Exhibit 3: Peer group comparison							
	Price	Currency	Market cap (m)	NAV (m) (last reported)	Cash/(debt) (m)	NAV multiple (x)	NAV per share (p)
Allied Minds	72.7	GBP	175.0	218	40	0.80	91
Arix Bioscience	136	GBP	184.4	270	91	0.68	200
IP Group	75.1	GBP	795.4	1218	219	0.65	115
Malin Corporation	3.80	€	173.6	392	(12)	0.44	8.57
HgCapital	221.5	GBP	891.8	802	102	1.11	215
Oakley Capital	235.0	GBP	481.3	575	212	0.84	281
Draper Esprit	550.0	GBP	648.6	619	100	1.05	524
Augmentum FinTech	112.0	GBP	105.3	98	44	1.08	104
					Mean	0.83	
					Median	0.82	
Mercia	31.7	GBP	96.1	126	30	0.76	41.6
Adjustment for embedded funds business				32			10.6
Mercia + Adjustment	31.7	GBP	96.1	158	30	0.61	52.1

Source: Refinitiv data, Edison Investment Research. Note: Priced as at 5 July 2019.

NAV excludes the embedded funds business

Mercia's strategic goals remain to grow the value of the direct investment portfolio, while also seeking to expand FUM to allow the group to reach a sustainable position over the medium term, where revenue covers expenses before realised gains and fair value movements.

These goals underline that the NAV-based valuation does not properly reflect the embedded value of Mercia Fund Managers, whose fees already cover a significant proportion of the group's net expenses. Placing these fees on a relatively conservative 3x EV/Sales multiple implies a value of £32m or 10.6p per share for Mercia Fund Managers (from 9p based on EV/Sales and P/E previously). Adjusting the NAV calculation for this embedded value (see Exhibit 3), suggests that Mercia is trading at closer to 0.61x the group's adjusted value.

In our view, this level of discount does not reflect either the strategic positioning of the portfolio or the strength of Mercia's underlying operating model.

Group overview

Mercia Asset Management

Despite the name change last week, Mercia's business model remains the same. Its stated intent is to become the leading regional provider of supportive balance sheet, venture, private equity and debt capital in transaction sizes typically below £10m.

Historically, Mercia has been closely associated with IP commercialisation. However, this categorisation no longer reflects the growth of the business, the diversity of its deal sourcing or the breadth of its investment portfolio, both debt and equity. Through its 19 university partnerships, IP commercialisation will remain an important element of Mercia's overall investment proposition, but today represents one of five principal sources of deal flow (the others being direct sourcing from Mercia's own network, client referrals, advisor referrals and cross-referrals).

Exhibit 4: Mark Payton, CEO on Mercia's FY19 results

 EDISON TV



Mark Payton
Chief Executive Officer, Mercia Technologies

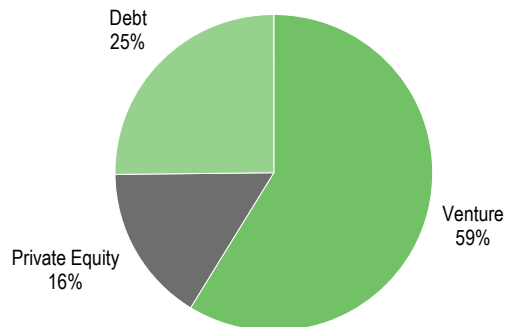
Source: Mercia Asset Management, Edison Investment Research

Funds overview

Mercia invests in both growing its pipeline and its existing portfolio companies through four pools of capital under management: balance sheet (£87.7m portfolio fair value, £30m unrestricted cash), venture (FUM £224.1m), private equity (£61.2m) and debt (£96.0m). In aggregate, the company manages assets under management (AUM) of c £500m, of which FUM accruing management fees represent £381m.

We include below introductory snapshots from the Fund Principals for each of for each of Mercia's three main business lines. Venture, including EIS and IP commercialisation, represents the majority (FY19: 59%) of the group's funds under management, but private equity (16%) and debt (25%) together represent a substantial proportion of overall funds.

Exhibit 5: Split of funds under management (FUM)



Source: Mercia Asset Management, Edison Investment Research

Fund performance and returns

To date, Mercia's closed and legacy funds have returned c £177m, with vintages varying from 10 to 16 years and with typical IRRs of 15–17%.

Venture – FUM £224.1m

Venture capital remains an important source of funding for entrepreneurial start-ups and young, growing companies. Mercia is one of the leading providers of venture capital and equity funding to small businesses in the UK regions, providing funding in the range of £0.05–2m across all sectors of the UK economy.

Exhibit 6: Will Clark, Fund Principal – Venture

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Source: Mercia Asset Management, Edison Investment Research

Private equity – FUM £61.2m

Through its EV Growth Funds, Mercia is one of the most active investors backing management teams looking to scale. It offers equity investment of up to £5m for purposes including expansion finance, to support management buyouts and buy-ins, acquisition finance, cash-out transactions and preparing for succession planning.

Mercia structures packages of debt and equity that deliver returns through a combination of yield, performance-related dividends and capital gain on exit, typically over a period of three to five years.

Exhibit 7: Wayne Thomas, Fund Principal – Private Equity EDISON TV

Source: Mercia Asset Management, Edison Investment Research

Debt – FUM £96.0m

Mercia provides debt funding ranging from £0.1m to £1m to both start-up and established businesses, across all sectors to businesses based anywhere in the UK.

Debt is available for a wide range of purposes: additional working capital to fund expansion plans, cover the cost of fulfilling a new contract or buying stock. Alternatively, businesses may need to borrow money to acquire a new property, improve existing premises or invest in plant machinery, new IT systems or other one-off business expenses. Mercia can often help in situations where banks and other lenders are unable to provide the full requirement.

Packages are tailored to individual business requirements with competitive rates and terms. Funding is typically for a period of up to five years, with rates fixed for the duration.

Exhibit 8: Paul Taberner, Fund Principal – Debt EDISON TV

Source: Mercia Asset Management, Edison Investment Research

Exhibit 9: Financial summary

	£'000	2015	2016	2017	2018	2019
31-March		IFRS	IFRS	IFRS	IFRS	IFRS
INCOME STATEMENT						
Revenue		508	1,755	6,660	10,197	10,675
Cost of Sales		(10)	(79)	(92)	0	0
Gross Profit		498	1,676	6,568	10,197	10,675
Operating costs		(1,495)	(4,011)	(9,051)	(10,633)	(12,115)
Fair value changes		3,934	896	4,268	2,823	3,916
Realised gains		0	0	839	871	0
Normalised operating profit		2,937	(1,439)	2,624	3,258	2,476
Amortisation of acquired intangibles		0	(17)	(301)	(301)	(301)
Exceptionals		(1,018)	(372)	(1,125)	(1,125)	0
Share-based payments		(44)	(230)	(395)	(497)	(171)
Reported operating profit		1,875	(2,058)	803	1,335	2,004
Net Interest		93	361	186	274	562
Joint ventures & associates (post tax)		0	0	0	0	0
Profit Before Tax (norm)		3,030	(1,078)	2,810	3,532	3,038
Profit Before Tax (reported)		1,968	(1,697)	989	1,609	2,566
Reported tax		0	0	54	54	54
Profit After Tax (norm)		3,030	(1,078)	2,810	3,532	3,038
Profit After Tax (reported)		1,968	(1,697)	1,043	1,663	2,620
Minority interests		0	0	0	0	0
Discontinued operations		0	0	0	0	0
Net income (normalised)		3,030	(1,078)	2,810	3,532	3,038
Net income (reported)		1,968	(1,697)	1,043	1,663	2,620
Basic average number of shares outstanding (m)		212	212	224	302	303
EPS - basic normalised (p)		1.43	(0.51)	1.26	1.17	1.00
EPS - diluted normalised (p)		1.43	(0.51)	1.21	1.13	0.96
EPS - basic reported (p)		0.93	(0.80)	0.47	0.55	0.86
Dividend (p)		0.00	0.00	0.00	0.00	0.00
Revenue growth (%)		(-29.7)	245.5	279.5	53.1	4.7
Gross Margin (%)		98.0	95.5	98.6	100.0	100.0
Normalised Operating Margin		578.1	-82.0	39.4	32.0	23.2
BALANCE SHEET						
Fixed Assets		27,121	50,103	63,693	77,428	98,724
Intangible Assets		2,455	11,815	11,514	11,213	10,912
Tangible Assets		49	145	151	145	153
Investments & other		24,617	38,143	52,028	66,070	87,659
Current Assets		54,349	31,730	64,576	53,965	31,180
Stocks		0	0	0	0	0
Debtors		716	798	747	1,057	782
Cash & cash equivalents		23,633	20,932	28,829	42,908	25,210
Short term liquidity investments		30,000	10,000	35,000	10,000	5,188
Current Liabilities		(631)	(1,521)	(6,698)	(7,760)	(3,730)
Creditors		(631)	(1,521)	(6,698)	(7,760)	(3,730)
Tax and social security		0	0	0	0	0
Short term borrowings		0	0	0	0	0
Other		0	0	0	0	0
Long Term Liabilities		0	(271)	(217)	(163)	(109)
Long term borrowings		0	0	0	0	0
Other long-term liabilities		0	(271)	(217)	(163)	(109)
Net Assets		80,839	80,041	121,354	123,470	126,065
Minority interests		0	0	0	0	0
Shareholders' equity		80,839	80,041	121,354	123,470	126,065
CASH FLOW						
Op Cash Flow before WC and tax		2,943	(1,406)	2,700	3,339	2,560
Working capital		(20)	650	5,250	(87)	(3,724)
Exceptional & other		(4,952)	(1,268)	(5,107)	(3,694)	(3,916)
Tax		0	0	0	0	0
Net operating cash flow		(2,029)	(2,024)	2,843	(442)	(5,080)
Capex		(27)	(113)	(82)	(75)	(92)
Acquisitions/disposals		(11,563)	(20,939)	(8,779)	(10,664)	(17,673)
Net interest		22	397	165	260	531
Equity financing		67,230	(22)	38,750	0	(196)
Dividends		0	0	0	0	0
Other		(30,000)	20,000	(25,000)	25,000	4,812
Net Cash Flow		23,633	(2,701)	7,897	14,079	(17,698)
Opening net debt/(cash)		(39)	(23,633)	(20,932)	(28,829)	(42,908)
FX		0	0	0	0	0
Other non-cash movements		(39)	0	0	0	0
Closing net debt/(cash)		(23,633)	(20,932)	(28,829)	(42,908)	(25,210)
Closing net debt/ (cash) inc short-term liquidity investments (not EIS)		(53,633)	(30,932)	(59,601)	(49,435)	(29,798)

Source: Mercia Asset Management, Edison Investment Research

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